



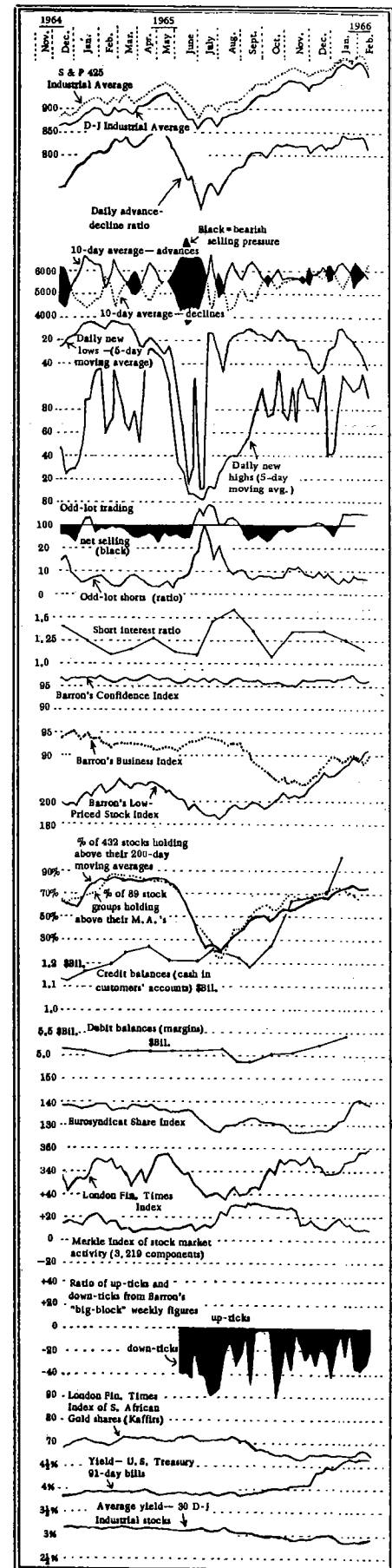
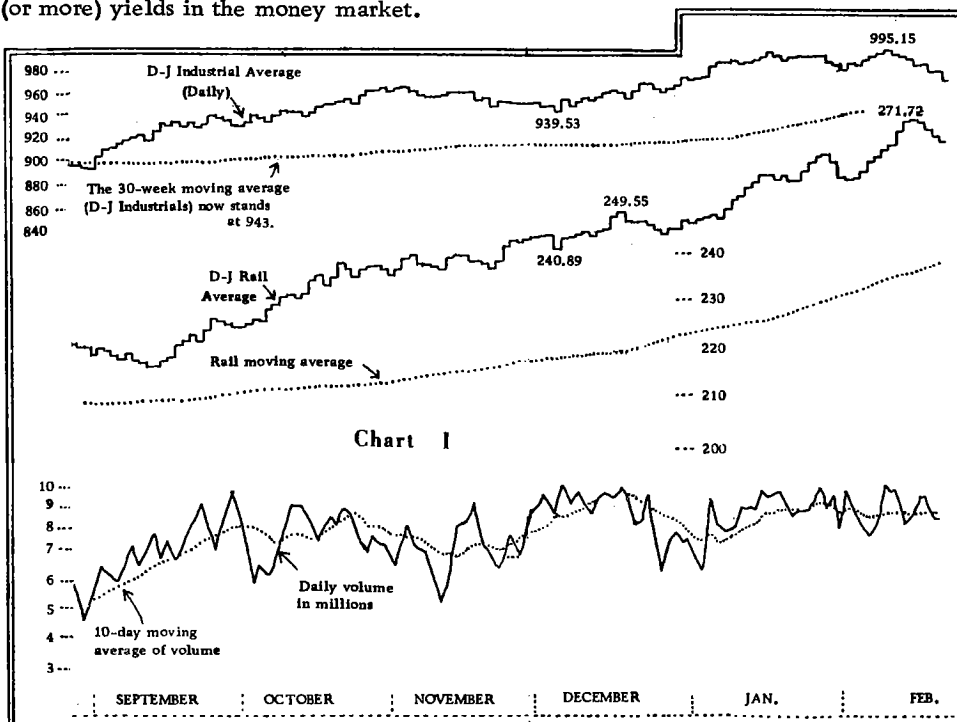
February 22, 1966

Letter 315

I dislike emphasizing "the drama of the marketplace" (in contrast with the cold, analytic approach), but it does seem to me that 1966 is shaping up as a most exciting year for market students. Not since 1907 has a booming economy run head-on into a monetary crisis, but I believe there is a reasonable chance that 1966 will see just that type of situation repeated. Furthermore, the monetary squeeze is occurring at a time when (unlike 1907) few businessmen, economists or Governmental leaders have the foggiest idea of the overall situation or the vaguest notion of how to deal with it. What we are seeing is an explosive demand for money from all sectors of the economy with a "built in" booster of \$1 billion a month for the Vietnam war—all this in the face of world money markets which are literally "panting for breath."

Here are a few of the important monetary developments of the past week or two. (1) The Export-Import Bank issued \$700 million of 7 year certificates to yield $5\frac{1}{2}\%$ (these certificates are fully guaranteed by the Federal Government). (2) The 91-day Treasury Bill yield rose to 4.69%, an all-time record high. (3) Leading N.Y.C. banks raised their rates on Certificates of Deposit of one year or more to $5\frac{1}{4}\%$. (4) Long-term Treasury bonds provided yields of 4.5% or more for the first time in 40 years. Intermediate-term Treasuries went to yields of over 5% in many cases. (5) The yield on (tax-free) municipal bonds rose on average to 3.75%, highest yield in six years. (5) Interest on U.S. savings bonds was raised to 4.15% in a feeble attempt to keep the savings bonds program from fading away completely.

THE MARKET: The performance of the Averages has been extremely "tricky" during 1966. For a month and a half the Industrial Average fluctuated within 2% of the fabled 1000 level. During this period the Rails climbed to record levels. On February 9 the Industrials rallied to an all-time high of 995.15, thus putting both indicators at new bull market highs for the first time since mid-January. Ironically, the joint new highs held for a single day. On February 10 the Industrials turned down and last week (February 17) saw the Industrial component break below 975.89, the February low. So far, the weakness has been most apparent in the Industrial sector, with Rails still well above their own February low of 257.91. One factor which is obviously exerting pressure on Industrials is their 2.9% average yield in the face of a variety of 5% (or more) yields in the money market.



That interest rates are exerting a braking effect on the market can be seen

in the succession of new lows in Utilities, a group which always adjusts itself to the trend of rates in the money market. But from a Dow Theory standpoint, it is still too early to tell exactly what the current weakness means. According to orthodox Dow Theory, once the two Averages record new bull market highs the significance of all previous points is erased. It is therefore the future path of the Averages which will determine whether this is to be merely a minor retreat preparatory to new highs or whether the current crack in this advance is to widen into a dangerous chasm.

At some point ahead a rally will materialize. The lows established by the current decline will then constitute the "critical levels" which, if they hold will provide hope for the bulls or, if they are subsequently broken, will provide fodder for the bears.

One other point should be mentioned. Past history suggests that the December lows of the preceding year (in this case the 939.55 Industrial low of December 1965) possesses a certain importance. In the great majority of cases, if the December low holds through the new year's first quarter, it is a good omen for the new year. Conversely, a breaking of the previous year's December low has been a bad omen for the market in general. For this reason it will pay all of us (1) to watch the action following the lows which will be established on this decline, (2) to keep our eyes on the 939.55 low recorded by Industrials in December, 1965.

Conclusion: the primary and secondary trends are still bullish, although the secondary trend could be in the process of turning down.

SUNDRY COMMENTS: The Honolulu conference has committed the U.S. to Premier Ky and his group in Saigon. Since it is debatable how well Premier Ky would do in an actual election, it is also understandable why the Premier wants little to do with events which might lead to an election. Ky has taken a stand against negotiating with the Viet Cong, and thus it appears to this observer that the Honolulu conference has placed the whole negotiations concept in a more difficult light. What does this mean? It means that the war is going to go on with the U.S. increasingly committed to a policy of total defeat of the Viet Cong.

Those who were hoping that Russia might intervene in the interests of peace were jolted last week as Russia again switched to the hard line of Vietnam. Even more unpleasant are the rumors that Russia is working with Castro (the result of the "Tri-Continental" meeting in Havana last month) in cooking up a "people's uprising" in Central America. Any uprising in Central America would have the effect of fomenting a "little Vietnam" on our doorstep. In the face of the Dominican Republic and the Vietnam problems one can only imagine the frustration that a third "front" would cause.

The Senate Foreign Relations Committee investigations have revealed the extent of the split in the nation regarding the conduct of the war in Vietnam. They have also revealed the Senate's anger and frustration at being bypassed by the President (remember, Congress declares war and ratifies treaties). The main lessons of the hearings, at least for this writer: (1) that Vietnam may be costing way out of proportion to its value, as per the Kennan and Gavin testimony; (2) that the power of the President is assuming fantastic proportions. The accompanying clip by New York Times Associate Editor James Reston further comments on this point.

* * * Statements of the Vietnamese war cost are beginning to emerge. Newsweek (Feb. 21) estimates the war could cost \$5 billion in fiscal '66, \$10 billion in fiscal '67, and if military pay raises and indirect costs are included, the cost will be \$15 billion this year. Comparison: the total four-year Korean war cost \$18 billion.

* * * There is an excellent chance that Russia is preparing to break completely with China. Here is my translation: in case of a Chinese-American war, Russia does not want to find itself in the position of being China's ally. Russia is sure of one thing, if there is a Sino-U.S. war, Russia will come out best of all.

* * * In their February Economic Report the First National City Bank of New York notes happily that "Only about one third of all families owe any mortgage debt; only about one half own any installment debt." I don't take such a cheerful view of these statistics. To me they mean that one third of America's families own all the mortgage debt, and that one half of America's families own all the installment debt. It means that one half of our population is up to its neck in debt, and that one half of our population would be in very poor shape to withstand even a slight recession. Here's a statistic the First National doesn't talk about: personal bankruptcies are up from 10,000 in 1946 to 163,000 in 1965.

* * * Note: I am aware that the majority of my subscribers are too busy to read widely from dozens of publications, then draw conclusions which may vary completely from the "accepted view." In these discussions I try to draw attention to the facts as I personally see them with "the chips falling where they may." From correspondence over the years, I know that my subscribers comprise one of the most intelligent and influential groups in the nation and throughout the world. My subscribers have minds of their own, and in many areas they undoubtedly disagree with me violently. All to the good. Where everybody thinks the same, thinking ceases.

By JAMES RESTON

WASHINGTON, Feb. 1—The power of the President to do what he likes on questions of war or peace has seldom been dramatized more sharply than in Mr. Johnson's conduct of the Vietnam war.

He has done almost everything in Vietnam he vowed publicly not to do. He has done it all legally, and in the process he has demonstrated that the American President now exercises personal power in the field of foreign affairs unequalled by any other political leader in the world.

He was against taking the Vietnam issue to the United Nations Security Council for judgment, but he presented it to the U.N. this week nevertheless. He opposed bombing North Vietnam when he ran for the Presidency, but he ordered the bombing after he was elected.

He was at first against defining war aims publicly, against committing a large expeditionary force to Vietnam, against a peace offensive, against committing his troops to offensive strategy of seeking out and destroying the enemy, and emphatically against risking a major ground war against superior numbers on the Asian continent—but he has done all these things in the face of sharp opposition within his own party and the nation.

The Composite Chart (page 1) continues to point to selected elements of weakness. A discussion of the advance-decline ratio appears in a later section. New lows are beginning to come in strongly. Odd-lotters, although not buying heavily, are still on the buying side of the market, and this is something new (and negative). Odd-lot shorts have held quite low on the current weakness, another negative indication. The latest short interest ratio is 1.15, neutral but not yet bearish. There has been marked improvement in many foreign markets. The London Average is near its recent high, despite horrendous deterioration in the British trade deficit for January. The yield spreads are fully discussed in other sections of this Letter. Conclusion: The majority of indicators shown on this chart appear to be signalling "caution."

ADVANCE-DECLINE RATIO: I have not discussed the advance-decline ratio in detail since Letter 310. But certain aspects of the current market suggest that this might be a good time to review the relationship of the A-D ratio and the Industrial Average.

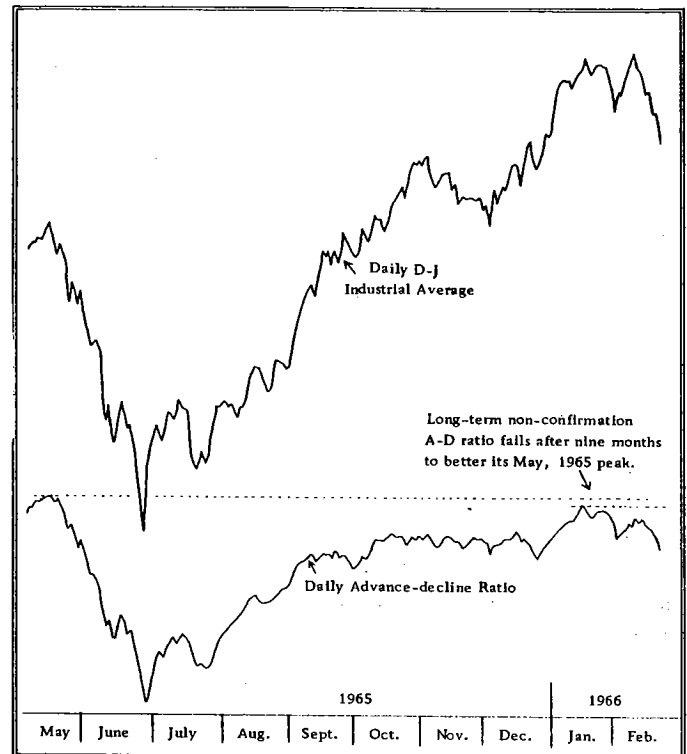
This relationship is normally one of harmony, with both Industrials and the majority of stocks (as measured by the A-D ratio) moving up or down together. The rather rare periods of divergence, however, are the ones which point up the value of the "breadth-price" relationship in technical analysis.

One peculiarity of the current market is that the A-D ratio recorded its last high in May, 1965 (see chart, page 3). A violent

correction occurred during May-June, 1965, and since that time Industrials have embarked on a broad advance to new record highs. The A-D ratio has followed more or less in direction, but it has never bettered its old 1965 high. In mid-January, 1966, the A-D ratio came within a fraction of the May, 1965 peak, but since that time the A-D ratio has retreated again.

It has now been nine months since the May, 1965 peak in the A-D ratio. Based on past case histories, we could be at or near a point where the price-breadth relationship assumes forecasting significance again. I believe it will be very important to observe whether the A-D ratio betters its old 1965 peak in the period ahead, or whether the A-D ratio refuses to penetrate that mark.

James Hughes of New York (who developed the A-D ratio along with Colonel Ayres of the Cleveland Trust Co.) noted that the following sequence should be watched carefully: (1) The A-D ratio and the Industrial Average both establish highs. (2) The Industrial Average then continues to record new highs but over a long period of time (Hughes uses four to nine months) the A-D ratio persistently refuses to record new highs of its own. Such extended periods in which the A-D ratio refuses to confirm new highs in Industrial, notes Hughes, are often the forerunners of major trouble.



Periods of four to nine month lag in the A-D ratio occurred in 1919, 1929, 1947, 1957, 1959 and 1962.

Each of these periods was followed by important declines or bear markets. However, the one great exception to this "rule" occurred during 1963-64 as many of my older subscribers well remember. The A-D ratio touched a peak in May, 1963, then moved sideways during the remainder of 1963 and most of 1964. On October 8, 1964, the A-D ratio finally bettered the May, 1963 peak. The belated and unprecedented confirmation occurred 17 months after the original 1963 peak.

In the current instance it has been nine months since the last A-D ratio peak. Enough time has elapsed so that I would judge that the breadth-price relationship is now unfavorable. However, with the 1963-64 exception so fresh in our minds, prudence dictates that we wait patiently for the actual outcome of the current lag in the A-D ratio. A forthcoming advance by the A-D ratio above its May, 1965 high would have the effect of reconfirming the bullish technical forces. Conversely, a continued refusal by the A-D ratio to better the 1965 high should be accepted as a "yellow light" for investors.

MORE ON MONEY: The writer continues to stress that the big story of 1966 is going to be money. It's a story that will affect the Federal Government and its domestic and foreign policies, the states, the municipalities, the cities and every individual citizen in the U.S. I have tried to brief subscribers on monetary problems well before they hit the financial headlines. I will continue to follow this policy, and here is the next chapter.

When the Federal Reserve Board raised the bank discount rate to $4\frac{1}{2}\%$, it also changed "regulation Q" thereby allowing banks to raise the ceiling on time deposits from $4\frac{1}{2}\%$ to $5\frac{1}{2}\%$. The reason for the latter was to allow the banks (via Certificates of Deposit) to raise their rates sufficiently to prevent a massive loss of deposits. After all, with Treasury bills now yielding 4.7% and most banks still paying only $4\frac{1}{4}\%$ to $4\frac{1}{2}\%$ on regular deposits, how long would it be before there was a "run" on bank deposits with bank money switching into higher yielding Treasury bills?

Even so, competition among banks and savings institutions has become intense. Rates across the country have risen, with leading banks now offering $5\frac{1}{4}\%$ for one-year Certificates of Deposit, and up to $5\frac{1}{2}\%$ for Certificates running to three years. This vicious competition for money has come in the face of a "cave-in" in the U.S. Treasury bond market. Many long-term Treasury bonds have now fallen to their lowest level in forty years, and the latest count shows 9 of the 40 listed Treasury bonds at yields of better than 5%. I might remind readers that in 1946 (at the height of the bull market in bonds), Treasuries yielding approximately 5% would have seemed almost as impossible as the Dow at 1000.

What are some of the results of the competition for money? For one thing, savers and those with cash are provided with a perfect "bargain bonanza" in the form of high returns on their money. Second, the competition is sending all fixed-income vehicles into severe bear markets with bonds, preferred stocks and utilities leading the way.

But there is a more ominous aspect of the rising rate picture—the rates are now beginning to squeeze the nation's financial institutions unmercifully. And the worst squeeze is hitting the weakest link, the savings & loan institutions.

The accompanying chart tells a dramatic story. Here we see the rate of growth of deposits at the savings & loan institutions heading down, and lately the downward trend has accelerated. The chart suggests that the 4.5% to 4.85% which the S & L's offer for deposits is failing to draw cash in the money markets. Rough competition from commercial banks (via C/D's) and

from Treasury and corporate bonds (via high yields) is taking its toll. The reason is obvious—would you rather be a partner (legally you are a shareholder) in a S & L at 4.85% or a debtor of the U. S. Government at 5% or a debtor at a commercial bank at better than 5%? The chart is providing the answer; the S & L's are losing out.

But the story does not end there. The savings and loans have financed a good portion of the construction boom throughout the nation and the greatest part of the boom in the West. These institutions hold \$ billions in mortgages, and they most definitely cannot afford a massive transfer of deposits to other higher yielding institutions. Any large exodus of S & L deposits could result in real trouble in the mortgage market, liquidation of mortgages, and a complete collapse in S & L profits.

What is the next step in the money picture? On February 14 the 91-day Treasury bill yield rose to 4.69%, an all-time record, while 181-day bill yields climbed to 4.87%. Because the bills are sold on a discounted basis, the 91's actually afford a true yield of about 4.80% and the 181's near 5%. Any time the bill rate pushes above the bank discount rate and stays there for a length of time (which is now the case), it is virtually certain that the discount rate will be raised. Thus I would now expect a new rise in the discount rate to 4 3/4 or possibly 5%. The Reserve Board could justify such a move as an attempt to stem inflation. Next, I would expect the limit on bank C/D's to rise to 6 or 6 1/2% and the prime rate to go to 5 1/2 or 6%.

What, in the final analysis, would another rise in the discount rate mean? Simply more of the same, more pressure in every section of the economy, and another step nearer the end for the bull market on Wall Street.

SPECULATIVE ACTIVITY: There are perhaps a dozen widely followed methods of appraising speculative sentiment on Wall Street. A few of these might be worth reviewing at this time.

(1) The time-honored method is simply watching N.Y.S.E. volume. As can be seen on chart 1, page 1, volume is now running at the highest rate in history. While much of this could conceivably be investment demand, the fact is that the 10-day average of volume has been holding in the 7 to 9 million share area since last September. Nothing like this has ever been seen on the N.Y.S.E. before.

(2) Volume on the more speculative American Exchange (AMEX) is also a good gauge of speculative activity. This has been leaping to very high levels recently. Perhaps an even more accurate variation of this is the ratio of AMEX to N.Y.S.E. volume. The ratio can usually be called "speculative" when it exceeds 35%. As seen on the accompanying chart (courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y.) this ratio has been in the above-35% area since last October.

(3) The public appetite for mutual funds (discussed in the last Letter) continues to be tremendous, and the December figures showed almost three fund shares purchased for every one redeemed. (The ratio was 37.) This is a very heavy rate of buying, and it might be added that December sales were the highest of any December in history. The astounding sales of the newly formed Manhattan Fund (a no-load mutual fund) is another indication of the public's appetite for mutual funds. Although the ability of Mr. Gerald Tsai (the fund's president) is an undoubted factor in the great success of the fund's inauguration, there is probably not a Wall Streeter who was not amazed by what occurred: the original offering a few weeks ago for Manhattan Fund was for \$50 million. A total of \$270 million came in, meaning that the Fund was oversubscribed by almost 500%. With all due regard for Mr. Tsai's ability, this is one whopping show of enthusiasm for Wall Street.

What does it all mean? Great enthusiasm for stocks is usually not sustained for very long on Wall Street. Enthusiasm can be dampened by a secondary reaction in a bull market. Or enthusiasm often occurs at (but more often prior to) a bull market top. The safest thing to say is that great speculative activity does not usually come at advantageous buying periods. Investment interests generally like to buy when all is quiet; they like to sell during high volume, speculative areas.

STOCKS: Recent Letters have discussed a number of individual issues such as Mack Truck, Alcoa, Westinghouse and Sunshine Mining. These were for readers who were in a position and of a mind to speculate. The great majority of my subscribers are now holding substantial quantities of cash with a hedge position of 10% to 20% in assorted goods. We cannot, at this point, know whether the market is midway in a secondary correction or sliding into a major bear market. But downtrends provide one valuable service; they allow us (as we did in May and June, 1965) to pick outstanding performers on the basis of relative strength. The best performers during a general market decline are frequently the best performers on the next major advance. This thesis will be discussed in detail in the next Letter.

